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ASSESSING UNSYSTEMATIC RISK: PART III—MARKET STRUCTURE

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Two previous articles in this series provided an overview of unsystematic risk assessment and a detailed discussion of macroenvironmental analysis. This installment deals with the next level of risk: the industry.

Risk assessment is a key aspect of valuing any company. The smaller the company, the more important accurately gauging risk becomes. We know that, notwithstanding misinformed IRS assertions to the contrary,[1] risk and company size really move in opposite directions. Hard data confirm that.

Unfortunately, when it comes to assessing unsystematic risk, we have little data. The 2000 issue of *Stocks, Bonds, Bills & Inflation*[2] includes industry risk premiums at the two-digit Standard Industrial Classification code level. That's a step in the right direction, especially for devotees of the "Chicago School," who often have argued against the very existence of unsystematic risk.

Moreover, the updated studies from Roger Grabowski and David King[3] offer valuation professionals some excellent data about size-related risk. Unlike the Ibbotson data which define size solely in terms of market capitalization of equity, these studies measure size from seven additional perspectives. For appraisers of businesses with revenues below $25 million, more such perspectives are better. The Grabowski/King dataset is available through http://valuation.ibbotson.com/Risk_Premia/price_waterhouse.asp.

Despite progress in the collection of data on the unsystematic-risk front, we have a long way to go. This series of articles gives valuation professionals an integrated model of risk that they can use to make qualitative analyses (which then they must quantify subjectively).

An ancillary and important benefit of this analysis is the depth it adds to the appraiser's understanding of *how the business works*. Through such understanding, we hope appraisers will escape the laundry lists and tick-and-tie mentality that too often slip past unsuspecting clients who don't know whether or not the appraisal is competent.

Like its macroenvironmental counterpart, industry analysis[4] is qualitative. In the macroenvironment, an individual company has very little power to change the forces. However, with imagination, commitment, perseverance, and some luck, managers *can* shape industry forces and influence them in favor of their company.[5] This is a key way to create competitive advantage.

[1] See "Expert Witness for IRS Attacks Size Premium Part of Discount Rate" by Michael Annin and Bruce Johnson, *Shannon Pratt's Business Valuation Update*, July 1999 (Vol. 5, No. 7), pp. 1+.

[2] From Ibbotson Associates, Chicago.

[3] See "New Evidence on Equity Returns and Company Risk," *Business Valuation Review*, September 1999, pp. 112–130.

[4] This is consistent with the AICPA Vision Statement.

[5] The extent to and effectiveness with which managers accomplish this is part of unsystematic risk assessment at the company level. We will address that issue in a later article.

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I continue to be amazed by appraisals that are done for clients by some of their long-time audit-and-tax CPAs. All too often it is clear that the CPA doesn't have the faintest idea of how the business works. The symptoms of this problem include:

- **Reliance on GAAP financials as the sole source of valuation.**
- **Capitalization of historical earnings as the primary valuation method.**
- **Mindless replication (and sometimes without attribution) of "economic outlook" pieces from such reputable vendors as Mercer Capital and WEFA.**
- **No elaboration about the *why* of ratio analysis.**
- **No disciplined approach to risk analysis and assessment.**
- **No definition of the industry in which the client company competes**
- **No discussion of market share or competitive behavior within the industry.**
- **No competitor analysis.**
- **No soup-to-nuts examination and analysis of the company itself, its strategy, its structure, its systems, its people, and so on.**

Five key factors drive industry analysis. In sequence, they are

1. Defining the industry.
2. Determining market structure.
3. Estimating relative market shares.
4. Applying Michael Porter's model of the five forces underpinning industry structure.
5. Making reasonable inferences from the analysis.

This article deals with the first three factors. The next installment will cover the latter two.

DEFINING THE INDUSTRY

Few companies that CPAs appraise are national competitors. Yet Ibbotson's risk premia, which most of us use, are drawn mostly from national players. In contrast, most of Grabowski's & King's data come from much smaller companies. For those of us valuing smaller companies, defining the industry, usually with geographical constraints, is crucial. That's because economic conditions within an industry usually vary according to its geographical dispersion. For instance, an industry which is fragmented nationally may become quite concentrated if it is defined regionally or locally.

The level of concentration bears, or should bear, on the competitive strategies chosen by incumbent players. Those strategies, in turn, affect profitability. The key is how the industry is defined.

Strategic Groups

In the strategy literature, subsets of industries are called *strategic groups.*[6] These provide a unit of analysis that lies between the industry and the company itself, an appropriate and useful level of analysis in valuing smaller companies. A strategic group consists of competitors who face the same external opportunities and threats. These opportunities and threats are usually different from those faced by national players or by other strategic groups. An industry may comprise many strategic groups.[7]

Members of a given group typically pursue similar strategies. In fact, the best way to divide industry competitors into strategic groups is to identify the major attributes of the individual companies' competitive strate-

[6] See *Competition in the Major Home Appliance Industry,* 1960-1970 (unpublished doctoral dissertation) by M. S. Hunt, Harvard University, 1972.

[7] For elegant, easy-to-comprehend discussions of the twin concepts of strategic groups and mobility barriers, see *Competitive Strategy: Techniques for Analyzing Industries and Competitors* by Michael E. Porter (New York: The Free Press, 1980), pp. 126-155, and *Gaining and Sustaining Competitive Advantage* by Jay B. Barney (Reading, Mass.: Addison-Wesley Publishing Company, 1997), pp. 125-133.

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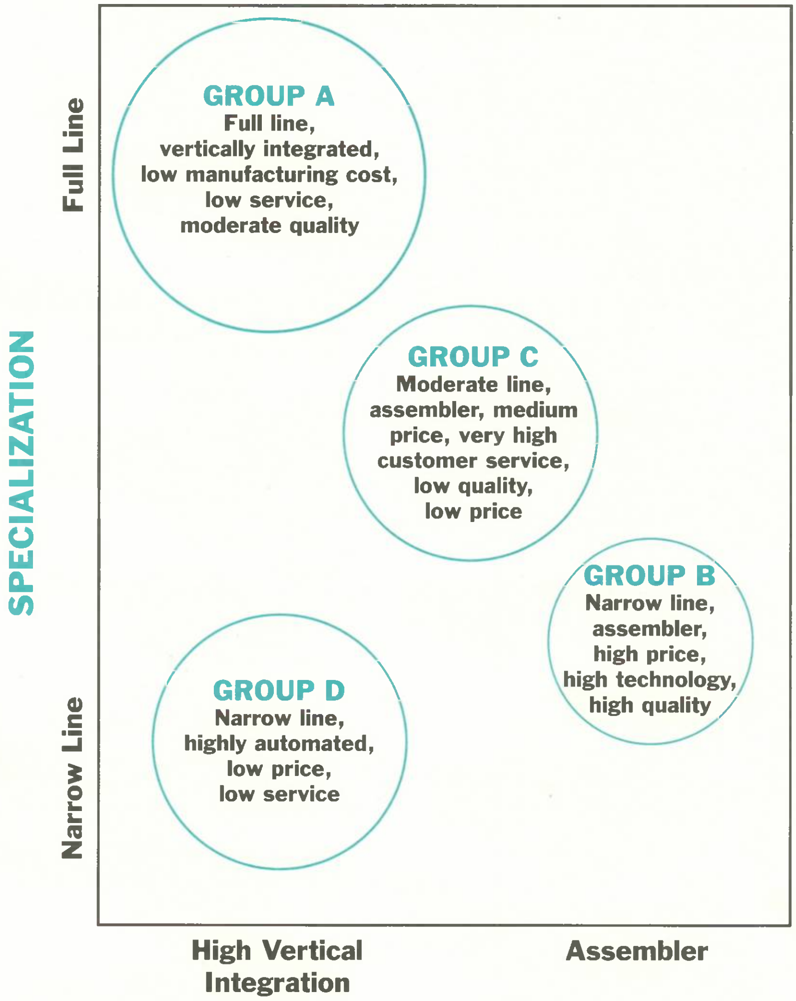
A Map of Strategic Groups in a Hypothetical Industry

Source: Competitive Strategy: Techniques for Analyzing Industries and Competitors, by Michael E. Porter, New York: The Free Press, 1980. Reprinted with permission.



gies—*how* they compete. Then the various groups can be mapped along two axes, the labels of which will be determined by the content of the different strategies. Use a circle to identify each group, varying the size of each circle to indicate the group's aggregate market share.

The strategic-group equivalent of an industry's barriers to entry are *mobility barriers.*[8] These barriers restrict movements of firms between groups within an industry. Strategic groups may differ by competitive strategy, customer group, distribution channel, product quality, pricing policy, brand identity, technological leadership, or other means of grouping like competitors in an industry. An analyst seeking to become an expert in a particular industry would enhance her or his understanding of industry dynamics by mapping the different strategic groups within the particular industry, identifying the relative mobility barriers separating them, and describing what binds the members of each group together.

Although the geographical parameter seems like a less-intuitive way of grouping firms, we have found that companies that compete head-to-head in a region or city usually deploy similar competitive strategies. That evidence, however, is strictly anecdotal.

It is important to compare the degree of concentration (or lack thereof) *and* the opportunities and threats faced by the valuation entity's strategic group with those of the industry nationally. The extent of their differences makes the case for defining the industry more narrowly. We invariably find substantive differences that warrant the narrower definition.

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[8] This phrase was coined by Richard Caves and his then-protege, Michael Porter, in their 1977 article, "From Entry Barriers to Mobility Barriers: Conjectural Decisions and Contrived Deterrence to New Competition" *Quarterly Journal of Economics,* 91, pp. 241-262.

We were engaged to determine whether a troublesome competitor in a niche of the apparel industry could either be purchased or neutralized. The competitor was a small, two-person company run by an unsophisticated owner who failed to realize that price-based competition in a concentrated industry (or strategic group) hurts everyone.

When we first approached her, she was adamant in her refusal to sell. Then, during the NASDAQ's whipsaw market correction of April 2000, her husband's employer was unable to meet a hefty margin call. The husband lost his $300,000 per year job in an industry that helped generate customers for her business. Her attitude about selling changed overnight.

With some handholding and reassurance, the disruptive owner was persuaded to sell at a bargain-basement price. A tightly worded noncompete provision resulted in significant increases in profitability for all members of the strategic group in question. By lowballing, the disruptive player was hurting everyone in this group—but especially herself.

DETERMINING MARKET STRUCTURE

More-concentrated industries (or strategic groups) are often more profitable than less-concentrated ones. The exception occurs with a disruptive competitor in an otherwise benign environment. In the case of an oligopoly (a market with few competitors), the disruptor competes on cost (that is, low price).[9] As every oligopolist knows, word travels fast in an oligopoly. A lower price for one means a lower price for all, so no one increases share by cutting price. The most obvious example is two gas stations at the same intersection, a classic small-scale duopoly.

An important question emerges: How can one estimate the market shares of the biggest players in each group? Insights into relative market share tell us about market structure, which has implications for likely competitive strategy, which feeds the analysis of competitive advantage, which drives the estimation of value.

Concentration Ratios

But before we can estimate market share, we need a tool to help us. Luckily, there's one we can adapt. Every five years the U.S. Bureau of the Census collects and publishes volumes of industry data (at the two-, three-, and four-digit SIC code levels) showing levels of concentration by SIC code, called concentration ratios (CRs). It calculates them for the largest 4, 8, 20, and 50 firms in an industry at the two-, three-, and four-digit level. A concentration ratio is the aggregate market share, expressed as a whole number, of the 4, 8, 20, or 50 biggest firms in an industry.

In mining and manufacturing, the concentration measure is units of output. In transportation, distribution, and services, the measure is dollars, even though the products generating those dollars may not be exactly comparable (for example, Motel 6 vs. Ritz-Carlton). More-concentrated industries are usually, but not always, more profitable than less-concentrated ones. That bears on valuation.

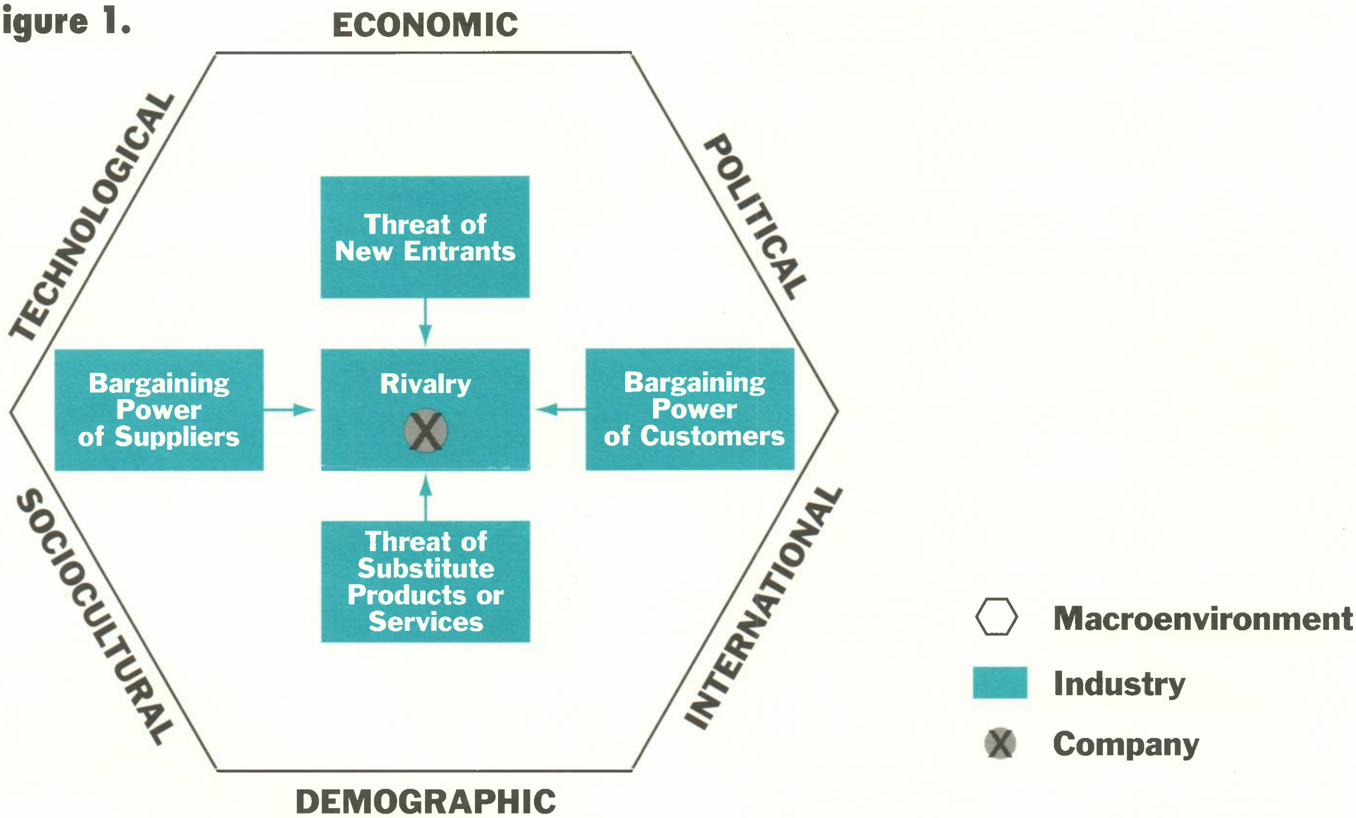
At one end of the concentration spectrum is monopoly (ultimate concentration). At the other end is "pure competition" (ultimate fragmentation, if you will). Somewhere in between lies oligopoly. For instance, the four-firm concentration ratio (abbreviated as CR4 in the census literature) in tobacco manufacturing (SIC 2111) is 93; the comparable figure in pallet manufacturing (SIC 2448) is 5. Highly concentrated industries tend to have highly differentiated products, which makes price a much less important consideration in their purchase. In contrast, fragmented industries, including most agricultural products, are often characterized by so-called "commodities," whose price is the primary, and often the only, consideration in the buying decision.

Sometimes, though, even in concentrated industries and strategic groups, price-based competition prevails. We see that phenomenon in audit services where the sole emphasis in the service offering is compliance, rather than adding value. Compliance is essential, of course, but there can be more to auditing than square-peg/square-hole activity. By failing to put some real meat on the bones of the management letter, auditors miss a key opportunity to add value, differentiate what they do, and increase prices (and margins).

Implicit in the concept of oligopoly is the notion that, because of their larger market shares, oligopolists' actions must recognize a degree of *inter*dependence between them. That, in turn, means that a firm's pricing decisions should not be made with merely its own self-interests in mind, but instead, the interests of the group (that is, the oligopoly). Overt price collusion is illegal, so good oligopolists practice "tacit collusion" whereby

[9] See my article, "The High Cost of Competing on Cost," in *The CPA Letter* (Business & Industry Supplement), May 2000, p. 4.

Figure 1.



pricing rules are understood through patterns of behavior—but not verbalized. The good (or ill) fortunes of one oligopolist are likely reflected in the good (or ill) fortunes of all. This is not the case in a commodity business.

CPAs often ask me where fragmentation stops and oligopoly begins. As with so many other issues in valuation that frustrate those with a low tolerance for ambiguity, there is no specific answer. In the first study done on the subject, Bain found that firms in industries with CR4s above 50 were more profitable than those in less-concentrated segments.[10]

Further, says a prominent industrial-organization expert:

> *[After Bain] studies of U.S. data also have found such a 'critical level' of concentration for CR4 between 45 and 60; that is, there is little evidence that increases in seller concentration to CR4 levels below 50 have any effect on profitability.*[11] *This assumes, of course, that relative shares are not unduly skewed to the point where one firm is dominant (has a market share greater than 40%). In dominant-firm segments, competitors, suppliers, and customers tiptoe around "the big gorilla."*[12]

As we suggested in the first installment in this series,[13] research data show that many strategic groups are more concentrated than the full industries of which they are a part. On a local and regional level, oligopoly is alive and well.[14]

ESTIMATING MARKET SHARES

Concentration ratios have traditionally helped economists infer the likely presence of oligopoly and other industry structures. In our shop, we have devised another use for the concentration-ratio construct: to help us estimate market shares of individual competitors and, by extension, the structure of the underlying industry or strategic group.

[10] See "Relation of Profit Rate to Industry Concentration: American Manufacturing, 1936-1940" by Joe S. Bain, *Quarterly Journal of Economics,* August 1951, pp. 293-324.

[11] Scherer, op. cit., p. 423.

[12] For a recent example, see the transcript of the recent antitrust action against Microsoft. Giants in industries outside Microsoft's bailiwick—operating systems—cowered, including such well-known companies as IBM, Compaq, and Hewlett-Packard. Only Sun Microsystems and Oracle remained consistently and resolutely antagonistic.

[13] "Assessing Unsystematic Risk," *CPA Expert,* Summer 1999, p. 4.

[14] *Ibid.*

Why does share matter? Because, without coming right out and using the phrase "market share," Revenue Ruling 59-60 seems to call for it:

> *It is important to know that the company is more or less successful than its competitors in the same industry, or that it is maintaining a stable position with respect to competitors.*[15]

The Headcount Proxy

We use the number of full-time equivalent (FTE) employees as a proxy for a company's sales. That's because, at some level, there is a correlation between headcount and revenues in a strategic group.[16] Within an industry or strategic group, it will vary from company to company depending on efficiency, management savvy, technology, etc., but, because an industry's economic underpinnings affect all players similarly, the relationship between sales and headcount must hold. It's not perfect, of course, but little in the valuation arena is.[17]

We ask the people running the valuation entity what they estimate their own market share to be, as well as those of their closest competitors.[18] Then, we use certain databases to estimate total employment in the strategic group we have defined. We could just as easily call companies or Chambers of Commerce to get headcount data—companies are *proud* of the number of jobs they've created in their communities![19] We estimate a company's market share based on its FTE employees as a percentage of total employment in the group. The headcount equivalent of the CR4, then—the sum of the headcounts of the four biggest competitors divided by the total group headcount—serves as the proxy for the aggregate market shares of the four biggest competitors. We now have an indication of concentration, which tells us a lot about market structure.

Industrial Organization

Bain's previously cited 1951 study was the first contribution to a field of economics that has come to be known as industrial organization (IO). Unlike traditional microeconomics with its assumptions about profit maximization, rationality, perfect information, and so on, IO is real-world economics. Its fundamental premise is that, within an industry, market structure, competitive conduct, and performance are related. This structure-conduct-performance model, as it's called, is extraordinarily useful for appraisers because it helps us make inferences about the future.[20] And, as we all know, valuation is nothing if not prospective.

Industrial organization matters to us because the original field of study of Michael Porter, originator of the famed "Five Forces Model," is IO. IO pervades that model. The next installment in this series will deal with the application of Porter's model to the appraisal of closely-held businesses. CE

Three aspects of IO set it apart from traditional microeconomics. The first is the unit of analysis—the industry (vs. the individual firm). The second is its reliance on empirical data, rather than on theory whose credibility is undermined by assumptions (profit maximization, complete rationality, perfect knowledge, and so on) that don't reflect everyday reality. The third is its explicit recognition that conduct affects outcomes; in traditional microeconomics, performance is preordained, determined by marginal cost analysis. In short, IO recognizes what other branches of economics deny: Behavior (read *strategy*) matters.

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[15] Section 4.02(b), Revenue Ruling 59-60.

[16] The correlation can't be too far out of whack or the group won't hang together because productivity (as measured by annual revenues per FTE employee) will be too disparate between companies.

[17] Being an appraiser is a lot like being a Marine: Lots of improvising is necessary.

[18] For reasons we have never been able to understand, most owners have uncommonly accurate perceptions about share, both their own and their competitors'.

[19] In contrast, closely held companies seldom want to talk publicly about what their annual sales are. That's why the 'headcount proxy' is necessary.[11]

[20] The Scherer book cited here is out of print. Recommended in-print tomes on IO include *Modern Industrial Organization* by Dennis W. Carlton & Jerry M. Perloff, *Applied Industrial Economics* by Louis Phillips (Ed.), London: Cambridge University Press, 1998; *Market Microstructure: Intermediaries and the Theory of the Firm* by Daniel F. Spulber, New York: Cambridge University Press, 1999.

VALUING COVENANTS NOT TO COMPETE IN A PROFESSIONAL PRACTICE

Mark Dietrich, CPA/ABV

Valuers often need to allocate the results of a business enterprise valuation to individual assets. The need may arise for tax or financial reporting purposes, or perhaps as a useful cross check or reality check of the results of a valuation based on an income or market approach. The need may also arise in a jurisdiction that does not recognize personal goodwill as an asset for distribution in divorce. One of the more common and difficult intangibles to value is the noncompetition agreement executed in connection with the sale of a professional practice. A covenant not to compete is, in part, the measure of the value of key management (workforce in place) included in the valuation. The value of the covenant is *not* in addition to the value of the business, but rather as part of it.

"WITH AND WITHOUT" INCOME METHOD

In order to value the covenant, the valuer must first value the entire business in the customary fashion. Next, the valuer must forecast the income lost to the business in the event the seller competes. To do this, the valuer prepares an alternate valuation in which he or she measures those profits attributable solely to the seller or (alternatively stated) those that would be lost if the seller did compete, in *each* year of the forecast. It should be noted that the period of time for the alternate forecast should be consistent with the length of the covenant. Next, the valuer must estimate the probability of competition in each year of the forecast and apply that probability to the lost profits attributable to the seller. The valuer then computes the present value and sums the result to determine the value of the covenant in the event of competition.

The steps in valuing the convenant are the following:

1. Complete the valuation of the business.
2. Estimate the probability of competition in each year of the forecast.
3. Prepare an alternate valuation assuming the seller competes, and estimate the profits attributable to the seller.
4. Compute the present value.

The present value of the probability-adjusted difference is the value of the covenant.

VALUE THE BUSINESS

It is not possible to value a covenant without knowing the underlying value of the business, unless the valuer has another source for estimating the profits of the business attributable to the seller. It should also be noted that the value of the business (less the tangible assets) represents an *absolute ceiling* on the value of the covenant and therefore should be determined in order to avoid overstating the covenant's value.

ESTIMATE THE PROBABILITY OF COMPETITION

The most common source of errors in valuing covenants is to ignore the impact of probability. It is rare for there to be a 100% likelihood that the seller will compete, and almost equally as rare for 100% of the profits in a business to be attributable to the seller. If all the profits in a business were attributable solely to the seller, it follows that all of the intangible value is personal goodwill, and none is business "goodwill" or intangible value. A business consisting solely of personal goodwill would be much more difficult to transfer and consequently would warrant a higher discount rate and a lower value, all other things being equal.

The typical practice valuation engagement may not generate all the information desirable for assessing the probability of competition. Certain information may be irrelevant to the actual transaction or may involve data the seller is unwilling to supply for perfectly valid reasons. On the other hand, in some cases, the likelihood of competition is quite readily apparent. Valuers should be familiar with applicable state law as to the enforceability of noncompetes and nonsolicitation agreements. A nonsolicitation agreement bars a seller from soliciting the services of an entity's employees for a new enterprise, for example, or soliciting former patients or clients. Other analogous provisions typical of

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purchase and sale agreements include prohibitions against 1) defamatory statements, 2) disclosure of trade secrets, and 3) use of "intellectual property" of the business or professional practice.

Another area of law that may be relevant in some circumstances, particularly those involving litigation, is the fiduciary duty owed a corporate entity by a shareholder-officer, to a partnership by a partner, or to an LLC by an LLC member. In some states, for example, a shareholder may be barred from attempting to usurp corporate opportunities for him- or herself. The definition of corporate opportunities could extend to patients, employees, and other valuable intangible corporate assets. In medical practices, there may be a strong counterweight to such prohibitions, however, because of the requirement for continuity of medical care, and the patient's ownership of the information contained in the medical record. The threat of litigation may therefore be a significant factor for the valuer to consider when assigning a probability to competition.

CONSIDER SPECIFIC FACTORS

The factors discussed in the following paragraphs probably do not exhaust the universe of potentially relevant considerations. The order in which they are presented here is relevant, however, and these factors are in the sequence recommended for consideration. Once a factor has made the probability of competition zero, consideration of other factors is, of course, unnecessary.

1. *Age and health of the seller* are commonly cited as the first and foremost factors in measuring probability. A 65-year-old physician selling a practice is unlikely to start up a new practice, even if in good health. If the seller is in poor health, the probability may decline to near zero.

2. *Seller's plans post-sale to relocate.* If a seller intends to relocate outside the existing practice's service area, the probability of competition may be near zero. If the seller has already moved, is advertising the current residence for sale, or has already purchased a new residence, the probability of competition is likely to be so low as to be nonexistent or irrelevant.

3. *Other business interests pursued by the seller, either locally or elsewhere.* It is common for physicians, for example, to have business interests outside their practices, whether related to medicine or not. The valuer may wish to inquire casually about the plans of the seller in this respect and pursue any relevant response.

4. *Difficulty of establishing a competing practice.* If the seller decided the day after the sale to open a competing practice, he or she would have to identify a site, acquire a billing system and make it operational, rehire old employees or hire new ones, and accomplish a host of other tasks. (*Author's note:* See a detailed discussion of this process at http://www.cpa.net/Enterprise.html).

5. *Prior evidence of sale and competition.* If a seller has started and sold several businesses or practices in a given geographic area, the valuer may have cause to assess the probability of competition at a higher level.

6. *State law regarding enforceability of noncompetes.* This factor could be listed earlier, but valuers generally are not qualified to make legal determinations and therefore should look first to other factors. Because of the threat and cost of litigation, a buyer's counsel will often insist on a covenant, even if it is likely to be unenforceable.

7. *Presence of* **pre-***existing noncompete agreements between the selling entity and its owner-employees or partners.* It is conceivable that a selling practice may already have a noncompetition agreement between its owners and the entity. A smart buyer will likely look to acquire these agreements, which can influence the determination of who "owns" the intangible assets of the practice and in some jurisdictions may influence the enforceability of a noncompete.

8. *Adequacy of sale proceeds to enable seller to retire.* It would be unusual for a sale of a small medical practice to generate sufficient assets for retirement. However, the valuer may become aware of other retirement assets

Can Lost Patients or Clients Be Recovered?

Alan Simons, CPA/ABV, of the Pennsylvania firm LarsonAllen, notes that a buyer may never truly "recover" lost patients or clients. Certainly, a surgeon who buys a practice and loses referrals to the competing seller will never recover those cases. If the seller recaptures patients (or clients) after a sale they again become the seller's patients. The seller's patients don't automatically become the buyer's if the seller stops practicing after a year. The term "recover" as used here should be seen as rebuilding the practice base, including referral sources.

Table 1: Probability of Competition Determined From Year of Transaction

	YEAR 1		YEAR 2		YEAR 3		TOTAL
	Compete	Don't Compete	Compete	Don't Compete	Compete	Don't Compete	Joint Probability
Compete in year 1	.50						.50
Compete in year 2		.50	.60				.30
Compete in year 3		.50		.40	.50		.10
Never compete		.50		.40		.50	.10
TOTAL							1.00

through the review of historical data, the contributions to pension or profit-sharing plans, or annual retirement plan filings.

9. *Other assets of seller (if known, or obtainable).* Aside from sales proceeds and retirement plan assets, other information about the seller's overall net worth may be very difficult to obtain, but the valuer should be certain to look for such evidence.

The assessment of the probability of a seller competing is the most critical and difficult task confronting the valuer. Rather than use a "rule of thumb," the valuer must carefully consider the particulars of the situation. After assessing the factors listed above and other relevant factors, the valuer prepares a table such as table 1, summarizing the likelihood of competition in each year covered by the covenant.

DETERMINE THE PROBABILITY OF COMPETITION

The valuer determines the probability for each year. Table 1, for example, shows that the probability of competition in year 1 is 50%; in year 2 (assuming no competition in year 1), the probability is 60%; and in year 3 (again, assuming no competition in year 1 or 2), the probability is 50%. The effective or *joint* probability in year 2 and 3 must account for the probability in year 1 in "decision tree" fashion. For example, the probability in year 3 must be multiplied by the probability of no competition in year 1 (100% – 50% = 50%) and year 2 (100% – 60% = 40%). The calculations of joint probability are:

Year 2: 60% * 50% = 30%

Year 3: 50% * 40% * 50% = 10%

The sum of the probabilities (the *joint probability*) of the possible occurrences must, of course, total 100%. Table 1 demonstrates that requirement. Note the *joint* probability that the seller will never compete is 10%.

ALTERNATE VALUATION

In a small medical practice, it is safe to assume that a substantial portion of the revenues and profits are attributable to the seller. In such a case, if the seller opened a competing practice the day after the sale, the buyer would likely obtain little of what was bargained for, aside from hard assets and the practice location. As a practical matter, however, in the absence of misrepresentation, the seller is unlikely to compete the very next day.

A valuation of the entire business establishes one ceiling on the potential value of the covenant. The alternate value establishes a second ceiling since it is designed to identify all of the profits attributable to the seller, if the seller were to remain in the business, without considering the responses of the buyer to retain the business if the seller were to decide to compete.

As noted on page 8 in number 4 "*Difficulty of establishing a competing practice,*" some time is likely to transpire between the sale and the commencement of competition. The seller may initially enjoy being retired but later decide it was the wrong decision. The longer this period of time, the greater the probability the buyer will retain some of the practice (or the profits attributable to the seller) that has been purchased. In addition, if the seller opens a competing practice, the buyer is unlikely to sit by idly and will attempt to preserve its investment. Therefore, when attributing profits to the seller in the forecast period of the alternate valuation, the valuer needs to consider both the *elapsed time* before competition commences as well as the *buyer's response.*

CASE STUDY

Consider the following case in which the valuer has attributed 75% of all profits to the seller as of the valuation date. The valuer also concludes that the risk of loss of profits to the seller's competition would decline from that 75% over time, and establishes 75% of the total profits attributable to the seller as the baseline loss in year 1. In determining this, the valuer must consider such things as the likely proximity of the competing seller's office and the nature of the practice (for example, primary care or specialty). In addition, the buyer's response actions would take several years to recapture the remaining lost profits. For example, in the first year, the 75% of the profits attributable to the seller are deemed to be lost (75% of 75%). In the second year, the buyer is estimated to recover 25% of that 75%, leaving 56.25% unrecovered. Finally, in the third year, 50% of the 75% is recovered, leaving 37.50% unrecovered. (See table 2.)

Table 2: Lost Profits in the Year Competition Begins

Year	% Lost	% Recovered	Net Lost
1	75.00%	0.00%	75.00%
2	75.00%	25.00%	56.25%
3	75.00%	50.00%	37.50%
4	75.00%	100.00%	0.00%
5	75.00%	100.00%	0.00%

To keep the example *relatively* simple, we assume that the effect of the seller's competing is limited to a three-year period, regardless of whether the seller begins competing in year 1, 2, or 3, and that the profits lost will not vary with the year the seller begins competing. (In reality, less profits would be lost the longer the seller waited to compete.)

Table 3 presents the base or original valuation along with the alternate valuation. Note that as of the valuation date, 75% of that year's profits are attributable to the seller, and that there is a 50-50 chance that the seller will compete.

The present value of the alternate valuation is not the value of the covenant. This determination is simply an interim step in computing the covenant's value, which computes the value of the business, or practice attributed to the seller assuming the seller is present in the business ($237,994) and the value attributed to the seller ($118,997) ignoring the multiplicative effect of probability.

The presentation in table 3 also indicates two common errors in use of this method: failure to account for the buyer's response to the seller's competing, and failure to adjust years after year 1 for the multiplicative effect of probability (the joint probability shown in table 3).

Table 4 starts with the present value of all profits attributed to the seller as of the valuation date ($35,276) and in year 1, multiplies that by the 75% that are estimated to be actu-

Table 3: Base Valuation and Alternate Valuation

YEAR		1	2	3	4	5	TERMINAL
Base valuation							
Free cashflow	30,600	51,504	42,125	47,134	49,229	48,670	355,534
Present Value (PV)	317,326	47,034	32,852	31,390	27,998	23,638	154,413
Alternate valuation							
% profits attributed to seller		75.00%	75.00%	75.00%	75.00%	75.00%	75.00%
PV profits attributed to seller	237,994	35,276	24,639	23,543	20,998	17,728	115,810
Probability of competing		50.00%	50.00%	50.00%	50.00%	50.00%	50.00%
Present Value	118,997	17,638	12,319	11,771	10,499	8,864	57,905

Table 4—Comparison of Lost Profits: Competition Beginning Year 1 v. Beginning Year 2

YEAR 1		1	2	3	4	5	TERMINAL
PV net profits		35,276	24,639	23,543	20,998	17,728	115,810
Net % attributed to seller		75.00%	56.25%	37.50%	0.00%	0.00%	0.00%
Net $ profit attributed to seller		26,457	13,859	8,829	0	0	0
Probability of competing		50.00%	50.00%	50.00%	0.00%	0.00%	0.00%
PV of lost profits	24,572	13,228	6,930	4,414	0	0	0

YEAR 2		1	2	3	4	5	TERMINAL
PV net profits			24,639	23,543	20,998	17,728	115,810
Net % attributed to seller			75.00%	56.25%	37.50%	0.00%	0.00%
Net $ profit attributed to seller			18,479	13,243	7,874	0	0
Probability of competing			30.00%	30.00%	30.00%	0.00%	0.00%
PV of lost profits	11,879		5,544	3,973	2,362	0	0

ally lost (taken from the table 2). The same pattern is followed for years 2 and 3. Note that this measures only the lost profits if the seller competes commencing in year 1. The seller is then assumed to continue to compete through the remainder of the three-year term of the covenant.

The second half of the chart computes the value of the lost profits if the seller commences competing in year 2. No lost profits are included from year 1 since the seller did not compete in that year.

Table 5 computes the value of the lost profits if the seller commences competition in year 3, and than totals the probability-adjusted present values for each year of the three-year covenant (24,572 + 11,879 + 3,612 = 40,063).

The estimate of profits attributable to the seller and the detailed assignment of probabilities create a complex mathematical model. Many valuers may find the task simplified by being certain (100% probability) that the seller would immediately compete in the absence of a covenant. Measuring the profits attributable to the seller is analogous to determining personal goodwill versus the enterprise (business) "goodwill" or intangible value. Valuers need to be certain they are familiar with the difference. CE

Author's Note: *The next edition of* The Medical Practice Valuation Guidebook, *scheduled for publication in April 2001, will include a detailed mathematical example and an author's insight and analysis section, as well as the spreadsheet for performing the computations.*

Table 5—Lost Profits If Competition Begins in Year 3

YEAR 3	1	2	3	4	5
PV net profits			23,543	20,998	17,728
% profits attributed to seller			75.00%	56.25%	37.50%
Net $ profit attributed to seller			17,657	11,812	6,648
Probability of competing			10.00%	10.00%	10.00%
PV of lost profits	3,612		1,766	1,181	665
Total value of covenant	**40,063**				

Expert Tools

KEEPING ABREAST OF INDUSTRY ISSUES

A Review of U.S. Industry & Trade Outlook 2000 *by McGraw-Hill Companies/U.S. Department of Commerce (ISBN 0-07-135245-7)*

Warren D. Miller, MBA, CPA/ABV, CMA

The death of the U.S. Commerce Department's *U.S. Industrial Outlook* in 1995 was a blow to thoughtful business appraisers. While the annual updated edition was not a definitive pronouncement on industry conditions at the level we require, it was an excellent starting place. In response to the hue and cry raised by our professional community, investors, and others, the *Statistical Abstract of the United States* expanded economic coverage in its 1995 and 1996 editions. Only late in 1997, after continuing complaints from professionals and researchers, did Commerce agree to a joint venture with McGraw-Hill to publish what is now the *U.S. Industry & Trade Outlook* (*USI&TO*).

Although six months late, the Y2K volume was worth waiting for. Like its predecessors, it's a huge enhancement of the old *Outlook*. The new *USI&TO* volume begins with five introductory chapters lettered A through E, which explain how to use the book, the economic assumptions underlying the data, the global economic outlook, e-commerce, and issue highlights. Chapter A says that the data are organized around the old Standard Industrial Classification (SIC) code scheme because the industry data based on the new North American Industry Classification System (NAICS, pronounced "nakes") "were released too late to have been included in *Outlook 2000*."[1]

As one would expect from its title, each of the remaining 54 numbered chapters in the *USI&TO* is devoted to a broadly defined industry. Within most chapters are sections focusing on different industry segments at the three- and four-digit SIC code level. Chapter lengths vary from 9 pages (Coal Mining) to 34 (Telecommunications and Navigation Equipment). Charts, graphs, and tables abound.

At the end of each chapter is a detailed bibliography, a list of related chapters, and a glossary of terms unique to the industries included. Similar chapters are grouped together under one of nine broader headings: Natural Resources and Energy; Construction and Related Industries; Industrial Materials and Components; Production and Manufacturing Equipment; Information and Communications; The Consumer Economy; Health Care; Financial, Business, and Education Services; and Transportation.

The 2000 version differs from its predecessor in minor respects. Some chapters have been shortened, others lengthened, and a few retitled and reorganized. The latter revisions reflect the evolution of our advanced industrial economy. For instance, the chapter that last year was called "Computer Software and Networking" this year is named "Software and Internet Technologies." It has been expanded from 22 pages to 32. And it covers eight industries now, up from four in 1999.

Similarly, "Medical and Dental Instruments and Supplies," which took up 5 pages last year, now occupies 22. It had no separate industry segments in 1999 but has five this year. "Space Commerce" went from 12 pages covering four industry segments to 32 subsuming seven. In contrast, "Motor Vehicles" shrank from 13 pages to 8, "Printing and Publishing" from 28 to 21 pages, and "Metalworking Equipment" from 17 to 12.

The *U.S. Industry & Trade Outlook 2000* will not be the sole source of industry data for serious valuation professionals. I use it in much the same way I use the *Handbook of Small Business Valuation Formulas and Rules of Thumb*[2] as a way to get up to speed on the issues and perspectives in an industry so I can speak knowledgeably with prospective clients.

The specific industry information in *USI&TO* will also help CPAs who provide litigation services. Its data is useful for calculating losses related to personal property, wrongful death, and employment discrimination and for determining commercial damages.

Warren D. Miller, MBA, CPA/ABV, CMA, is co-founder of BECKMILL Research, Lexington, Virginia; e-mail: wmiller@beckmill.com; phone: 540-463-6200. He is a member of the Accredited in Business Valuation (ABV) Examination Subcommittee.

[1] *U.S. Industry & Trade Outlook 2000* by McGraw-Hill Companies/U.S. Department of Commerce (ISBN 0-07-135245-7), p. A-1.

[2] *3rd Ed.* by Glenn M. Desmond (Camden, Me.: Valuation Press, 1994.)

USI&TO doesn't explicitly deal with what Michael Porter calls "the structural analysis of industries."[3] So, for those seeking perspectives on the economic underpinnings of an industry, this book isn't much help. Serious industry analysis requires other resources. But *USI&TO* should be a regular component of every appraiser's annual reference-book budget. It's a cost-effective addition to any library.

The book is available in print, on CD-ROM, and by chapter download. Individual chapters can be downloaded in Adobe (.pdf) format at www.ntis.gov/product/industry-trade-chapters.htm; a link to free Acrobat Reader software is on that site. Chapters are $10 each except for "Chemicals & Allied Products," "Computer Equipment," "Computer Software & Internet Technologies," "Electrical Equipment," "Household Consumer Durables," "Information Services," "Printing & Publishing," and "Telecommunications & Navigation Equipment," each of which goes for $25. A caveat: Unless you have the full Adobe Acrobat software (which costs about $200), you cannot manipulate downloaded text or graphics.

Print and CD-ROM editions can be ordered by dialing toll-free (800-553-6847) or on the Web (www.ntis.gov/product/industry-trade.htm). Costs, including handling, are $74.95 for the print version and $130 for the CD-ROM; the government "takes plastic." CE

[3] See *Competitive Strategy: Techniques for Analyzing Industries and Competitors* (Revised Edition) by Michael E. Porter (New York: The Free Press, 1999).

Expert Tools

REVISITING A CLASSIC

A Review of Valuing a Business: The Analysis and Appraisal of Closely Held Companies, *4th edition, by Shannon P. Pratt, Robert F. Reilly, and Robert P. Schweihs, McGraw-Hill, 2000.*

R. James Alerding, CPA/ABV, ASA, CVA

Recently, McGraw-Hill published the fourth edition of *Valuing a Business* by Shannon P. Pratt, Robert F. Reilly, and Robert P. Schweihs. I had the privilege of reviewing this edition before publication. Reading this seminal work from cover to cover for the first time in many years was like re-reading a Dickens classic. Time has not dulled its edges. The elements of the original edition are still there, but significant additional materials enhance them.

Since the first edition, the body of knowledge of business valuation has grown significantly. Dr. Pratt and his associates have drawn on their many years of experience and their significant other publications to once again produce the premier business valuation text.

PRIMARY SOURCE

Valuing a Business is a must in the library of the valuation professional. It will continue to be the primary source of the body of knowledge for both valuers and attorneys. It is laid out logically and indexed for ease of use. The authors expand on the details of application of particular methodologies. For example, in the section dealing with the application of the Weighted Average Cost of Capital (WAAC) methodology, the authors explain that, "...to value the capital structure by this definition...it is necessary to include the interest on long-term debt in the income being discounted and treat other interest (such as on a bank operating line of credit) as an expense." These nuances are helpful to the valuer in practice, especially when involved in litigation.

Valuing a Business has more than 900 pages (and they are not small pages) covering every element of the valuation profession. There are tables, charts, exhibits, plenty of cross references, and a bibliography. It includes the new glossary of terms agreed on by the AICPA and four other professional valuation associations. We thank Dr. Pratt primarily for the continued excellence of this text. For many years it has provided the bedrock of the valuation profession and it will continue to do so for the foreseeable future. CE

R. James Alerding, CPA/ABV, ASA, CVA, is with Clifton Gunderson, LLC, Indianapolis. He is a member of the AICPA Business Valuation Subcommittee.

FYI...

FEDERAL CREDENTIALS FOR ADR?

The Federal Mediation and Conciliation Service (FMCS) wants to credential outside private and public sector mediators in four specific dispute resolution disciplines: labor, employment, commercial, and regulatory negotiations. FMCS would maintain a list of credentialed neutrals for use by government agencies. The qualification of mediators by experience and discipline, along with continuing education and ethics training will be available on line to the public in October, 2000.

FMCS Director Richard Barnes said the program would be "in the public interest" because it would "establish standards of training, ethics, and practice" for ADR practitioners. According to Barnes, credentialing "distinguishes persons who meet requisite standards from those who do not; however, credentialing does not restrict persons from the activity to the extent that licensure and certification do. Credentialing relies upon the principles of free market choice for consumers of the service."

Some private alternate dispute resolution (ADR) practitioners support the plan because they believe it will help raise standards for mediation in the federal sector. Opponents argue that the plan will stifle competition. Some federal agency staffers question FMCS's authority to develop the program.

USING ADR IN B2B E-COMMERCE

In response to the rapid development of business-to-business electronic commerce and the prevailing legal uncertainty in the area, New York-based CPR Institute for Dispute Resolution developed four tools to assist participants in this market.

The four tools are:

▲ *The CPR Global E-Commerce Commitment* helps companies engaged in electronic business-to-business transactions by (1) setting forth principles of contract formation to which companies may agree, and (2) providing a voluntary, non-binding method that companies can agree upon to attempt to resolve disputes arising from electronic contracts in a rational, efficient, and businesslike manner.

▲ *The CPR B2B E-Commerce ADR Commitment* is identical to the CPR Global E-Commerce Commitment, except that it does not address contract formation. Signers commit only to a method of voluntary, non-binding dispute resolution.

▲ *The CPR Model ADR Provision for B2B E-Contracts* is a model ADR provision designed for inclusion in the standard electronic contract forms that businesses use with vendors, suppliers, customers, and other regular business partners. It provides for negotiation and mediation of disputes arising from the contract, with an optional provision for binding arbitration.

▲ *CPR Model ADR Provision for B2B Platforms and Exchanges* is a provision recommended for horizontal and vertical exchanges that impose uniform conditions upon participants in the exchange. Its purpose is to ensure that dispute resolution is addressed at the front end of transactions on the exchange and to provide sellers and buyers with a modicum of certainty that they will have a procedure for recourse in the event of a disagreement about contract formation or performance, with a procedure intended to be business-driven rather than legalistic.

Copies of the tools are available on CPR's Web site, along with a discussion of the background of the initiative (www.cpradr.org).

A RECOMMENDED RESOURCE

At the 2000 AICPA/IIA National Conference on Fraud, held in Las Vegas, September 20–20, two speakers recommended that participants look at an AICPA publication on fraud. In separate sessions, John Hall, director of fraud risk management for Ernst & Young's Chicago area internal audit services practice, and Bert Lacativo of FTI Consulting, Dallas, Texas, told participants that they may find *The CPA's Handbook of Fraud and Commercial Crime Prevention* useful in the prevention and detection of fraud. The book includes checklists on a companion Microsoft Word disk and bimonthly issues of a newsletter, *Report on Fraud*. The book, in loose leaf format, is updated annually More detail about its contents is available on the AICPA Web site at www.aicpa.org/store/products/056504.htm.

AICPA members pay $180; nommembers pay $225. The product number is 056504CX. To order call the AICPA member satisfaction team at 888-777-7077. CE

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Preliminary Agenda

(Session topics are subject to change.)

TRACKS: C Core   A Advanced   PM Practice Management

Pre-Conference Workshop — Saturday, November 11, 2000

3:00pm– 6:00pm
C 100. **Passion Play — Sacks Restaurant Business Valuation Revisited (SK)** *(additional fee)*

Pre-Conference Workshops — Sunday, November 12, 2000

9:00am–12:00pm 101. **Restaurant and Bar Valuation** (additional fee) (Part 2 of 5-part optional workshop series)
102. **TECH Expo** (FREE)

Main Conference Begins — Day One — Sunday, November 12, 2000

1:00pm–6:00pm Registration and Message Center Open
1:00pm–1:15pm Welcome and Introduction
1:15pm–2:30pm 1. **Keynote Address by Ambassador Alan Keyes**
2:30pm–3:00pm Refreshment Break and Exhibits
3:00pm–4:15pm Concurrent Sessions (select one)
C 2. **Intellectual Property and Intangibles**
A 3. **Introduction to Real Options**
PM 4. **How to Conduct Due Diligence Reviews**
4:15pm–4:30pm Break
4:30pm–5:45pm Concurrent Sessions (select one)
C 5. **Web-Based Resources**
A 6. **Valuations for Mergers and Acquisitions**
PM 7. **Preparing Yourself for the Litigation Environment**
5:45pm–6:00pm Break
6:00pm–7:15pm General Session
8. **The Latest Business Valuation Issues — Point/Counterpoint**
7:15pm–8:15pm **Welcome Reception**
8:15pm–9:15pm **ABV Reception** *(By Special Invitation Only)*

Day Two — Monday, November 13, 2000

7:00am– 5:00pm Registration and Message Center Open
7:00am– 8:00am Continental Breakfast and Exhibits
8:00am– 9:00am General Session
9. **The Future of the Profession**
9:00am–10:00am General Session
10. **Valuation Jeopardy**
10:00am–10:30am Refreshment Break and Exhibits
10:30am–11:45am Concurrent Sessions (select one)
C 11. **Valuation Verdicts: Current Year Opinions Every Valuator Should Understand**
A 12. **Valuations and Considerations Related to Family Limited Partnerships**

Day Two — Monday, November 13, 2000 *(continued)*

PM 13. **How to Become Famous in the Valuation Niche**
11:45am–1:30pm Lunch and Luncheon Address
1:30pm–2:45pm Concurrent Sessions (select one)
C 14. **Practice Makes Perfect — Valuing Professional Entities**
A 15. **Advanced Discounts and Premia**
PM 16. **Selling Your Services**
2:45pm–3:00pm Break
3:00pm–4:15pm Concurrent Sessions (select one)
C 17. **Negotiation Skills for the Business Valuator**
A 18. **Assessing Unsystematic Risk**
PM 19. **Valuation Land Mines to Watch Out For**
4:15pm–4:45pm Refreshment Break and Exhibits
4:45pm–6:00pm Concurrent Sessions (select one)
C 20. **Court-Appointed Expert**
A 21. **Using Ibbotson Data in Business Valuation Engagements**
PM 22. **Marketing Your Business Valuation Services**
6:00pm–7:00pm 103. **ABV Accreditation Roundtable**

Day Three — Tuesday, November 14, 2000

7:00am–12:30pm Registration and Message Center Open
7:00am–7:50am Optional Morning Roundtables (select one)
104. **Ask the Experts — Discounts and Premia**
105. **Ask the Experts — Litigation Area**
106. **Ask the Experts — Report Writing Critique**
7:00am– 8:00am Continental Breakfast and Exhibits
8:00am– 9:30am General Session
23. **Valuator as Consultant — Creating Value**
9:30am– 9:45am Refreshment Break and Exhibits
9:45am–11:00am Concurrent Sessions (select one)
C 24. **Forensic Topic**
A 25. **Valuations and Considerations Related to Family Limited Partnerships** (Repeat of session #12)
PM 26. **Going Beyond the Case: Painless Prospecting for the 10 Symptoms of the Underachieving Law Firm**
11:00am–11:15am Break
11:15am–12:30pm Concurrent Sessions (select one)
C 27. **Practice Makes Perfect — Valuing Professional Entities** (Repeat of session #14)
A 28. **Valuation Consideration When the Subject Company Is a Candidate for an IPO**
PM 29. **Marketing Your Business Valuation Services** (Repeat of session #22)
12:30pm Conference Adjourns

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3:00pm– 6:00pm ☐ 100

SUNDAY, NOVEMBER 12, 2000

Pre-Conference Workshops

9:00am–12:00pm ☐ 101 ☐ 102

Conference Sessions

3:00pm– 4:15pm ☐ 2 ☐ 3 ☐ 4
4:30pm– 5:45pm ☐ 5 ☐ 6 ☐ 7

MONDAY, NOVEMBER 13, 2000

10:30am–11:45am ☐ 11 ☐ 12 ☐ 13
1:30pm– 2:45pm ☐ 14 ☐ 15 ☐ 16
3:00pm– 4:15pm ☐ 17 ☐ 18 ☐ 19
4:45pm– 6:00pm ☐ 20 ☐ 21 ☐ 22

TUESDAY, NOVEMBER 14, 2000

7:00am– 7:50am ☐ 104 ☐ 105 ☐ 106 (Optional Roundtables)
9:45am–11:00am ☐ 24 ☐ 25 ☐ 26
11:15am–12:30pm ☐ 27 ☐ 28 ☐ 29

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